IN THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

MICHAEL D. GIBBONS, Plaintiff,	)	
v.	)	No. 10 Civ. 8640 (BSJ)
JOHN C. MALONE, Defendant	)	
and	)	
DISCOVERY COMMUNICATIONS, INC. Nominal Defendant	)	

**MEMORANDUM OF LAW IN SUPPORT OF
DEFENDANT JOHN C. MALONE'S MOTION TO DISMISS**

Plaintiff brings this 16(b) action to have this Court direct Defendant John C. Malone to disgorge theoretical "deemed" profits based on his sales of one equity security and purchases, by a related trust, of a *different* security—one that constitutes a separate class of stock where neither security is convertible into, or exercisable for, the other or the same security—an unprecedented legal position. Plaintiff's request for relief cannot be squared with Section 16(b) of the Securities Exchange Act of 1934, the so-called "short-swing profit" law, which applies to transactions involving **the same equity security**. As the Second Circuit long ago recognized, the notion that Congress intended Section 16(b) "to permit a recovery where stock of one class is purchased and the stock of another class sold . . . is beyond the realm of judicial fantasy." *Smolowe v. Delendo Corp.*, 136 F.2d 231, 237 n.13 (2d Cir. 1943); *see also Levy v. Sterling Holding Co.*, 544

F.3d 493, 496 (3d Cir. 2008) (liability under Section 16(b) requires "(1) a purchase of a security and (2) a sale *of that security*" within six months) (emphasis added). The Court should decline to engage in that "judicial fantasy" here.

Not a single court, nor the Securities and Exchange Commission (the "SEC" or "Commission"), has ever concluded that Section 16(b) can be applied to transactions involving different securities unless those securities are convertible into, or exercisable for, each other or a third common security. And for good reason. Extending Section 16(b) beyond that narrow class of transactions would contravene both the text and the express purpose of the statute: to create a bright-line rule that captures those transactions posing the greatest risk of insider abuse but, at the same time, is easy for courts to apply and statutory insiders to follow. Adopting Plaintiff's novel position—that disgorgement can be required for *any* transactions that may "giv[e] rise to the kinds of abuses Section 16 is intended to curtail," Compl. ¶ 48—would re-write the statute and gut its bright-line rule. It would extend Section 16(b) to an entirely new, ill-defined class of transactions—one that neither the courts nor the SEC has ever suggested could be subject to Section 16(b). And it would create a trap for the unwary, expanding the undeniably "Draconian" effects of Section 16(b)'s strict liability rule well beyond what Congress intended or any statutory insider, including Mr. Malone, could anticipate.

Because the Complaint seeks disgorgement based on a series of transactions that are beyond the scope of Section 16(b), it fails to state a claim upon which relief can be granted. Mr. Malone respectfully requests that the Complaint be dismissed under Federal Rule of Civil Procedure 12(b)(6).

FACTUAL BACKGROUND

In December 2008, John Malone was a director of Discovery Communications, Inc. ("Discovery") and an owner of two relevant classes of Discovery's stock, Series A Common Stock ("class A") and Series C Common Stock ("class C"). Compl. at ¶¶ 13, 21, 23, 27. During the period identified in the Complaint (December 5 to December 17, 2008), Mr. Malone purchased, through one or more trusts related to him, shares of class A stock and, in his individual capacity, sold shares of class C stock. *Id.* ¶¶ 33–41. According to the Complaint, those transactions in separate, distinct securities resulted in a "deemed profit" for Mr. Malone subject to disgorgement under Section 16(b). *Id.* ¶¶ 56–58.

The Differences Between Class A And Class C Shares. The differences between class A and class C shares are plain from the face of the Complaint. Owners of class A stock are entitled to one vote per share. *Id.* ¶ 45. Class C stock, by contrast, is non-voting. *Id.* Neither class of stock is convertible into the other or into any other security into which both can be converted. Moreover, while a third class of Discovery common stock ("class B") is convertible into class A stock, it is not convertible into class C stock. *Id.*, Exh. A-14. Class A and class C shares also have different rights regarding share distributions: holders of class A shares are entitled to receive stock dividends consisting of class A shares but holders of class C shares are not. *Id.*, Exh. A-15.

In addition to having fundamentally different features, class A and class C shares also trade differently in the market. Each class trades separately on NASDAQ under a different ticker symbol (DISCA and DISCK, respectively). *Id.* ¶¶ 15, 17. Moreover,

there was, at the relevant time, a market in third-party put/call options for shares of class A stock, but not for shares of class C stock.[1]

As the price chart attached to the Complaint shows, class A shares and class C shares do not trade at the same price; nor is the difference between their trading prices constant. *See id.*, Sched. III-1. For example, on January 5, 2009, class A shares closed $0.92 higher than class C shares; the next day, that difference shrank to $0.54. *Id.*, Sched. III. On October 15, 2008, class A shares closed only $0.02 higher than class C shares; the next day, the closing price of class A shares rose and the closing price of class C shares *fell*, with class A shares closing $0.62 higher than class C shares. *Id.* As this example shows, it is not the case that the respective prices of class A and class C shares always move in the same direction. To the contrary, between September 18, 2008, and February 2, 2009, their respective closing prices moved in opposite directions on fifteen separate occasions. *See id.* (showing closing prices for 9/19/08-9/22/08; 10/15/08-10/16/08; 11/19/08-11/20/08; 12/1/08-12/2/08; 12/23/08-12/29/08; 1/8/09-1/9/09; 1/22/09-1/23/09; 2/2/09-2/3/09; 2/6/09-2/9/09; 2/12/09-2/13/09; 2/18/09-2/19/09; 2/20/09-2/23/09). Moreover, on five of the days identified in the Complaint, class C shares closed at a price higher than the price of class A shares. *See id.* (showing that class C shares closed higher than class A shares on 9/18/08, 9/22/08, 9/29/08, 11/20/08, and 11/28/08).

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[1] Options for class A stock were listed on September 23, 2008, whereas options for class C stock were not listed until August 28, 2009. Exh. 1, Options Clearing Corporation's new listings for April 2008 and August 2009, available at http://www.optionsclearing.com/market-data/series/new-listings/2008/sep.jsp and http://www.optionsclearing.com/market-data/series / new-listings/2009/aug.jsp.

The Allegations In The Complaint. Plaintiff acknowledges that class A stock and class C stock each constitute a separate "class of Discovery's equity securities." *Id.* ¶¶ 21, 23. And he makes no claim that the shares are economically equivalent. To the contrary, Plaintiff recognizes that the classes differ fundamentally in their voting rights. *Id.* ¶ 45. Nonetheless, Plaintiff alleges that the difference in voting rights is "[t]he only economically material difference" between the two classes. *Id.* Despite the fact that the price history attached to the Complaint shows that class A and class C shares trade separately with varying price differentials—with their prices at times moving in opposite directions—Plaintiff contends that the prices of the two classes are "highly correlated"; that "an insider could benefit from inside information" by trading across these two classes; and that therefore transactions involving class A and class C shares "giv[e] rise to the kinds of abuses Section 16 is intended to curtail." *Id.* ¶ 48. Based on those allegations, Plaintiff claims that Mr. Malone's sales of class C shares and purchases of class A shares between December 5 and December 17, 2008, are subject to Section 16(b)'s strict liability disgorgement requirement.

Plaintiff proposes to measure the profits from purchases of class A shares and sales of class C shares by creating a "deemed" purchase price for class A shares equal to the price of class C shares on the date of each purchase. *Id.* ¶¶ 49–50. To justify this methodology, Plaintiff alleges that the price of a share of class A stock is merely the sum of the price of a share of class C stock plus what Plaintiff describes as the "value of one vote." *Id.* Plaintiff does not attempt to make his theory accommodate the days when

class A shares closed at a *lower* price than class C shares—which, in Plaintiff's theoretical world, would mean that the vote had a negative value at those times.

LEGAL STANDARD

Under Federal Rule of Civil Procedure 12(b)(6), a court must dismiss a complaint if it fails to "allege facts [that] confer a judicially cognizable right of action." *York v. Ass'n of Bar of City of New York*, 286 F.3d 122, 125 (2d Cir. 2002). In considering a motion to dismiss, a court must take the allegations of the complaint as true, but may also "consider documents that are incorporated into the complaint by reference or attached to the complaint as exhibits." *Gryl ex rel. Shire Pharms. Group v. Shire Pharms. Group*, 298 F.3d 136, 140 (2d Cir. 2002) (citation omitted). Likewise, a court may refer to documents publicly filed with the SEC. *I. Meyer Pincus & Assocs. v. Oppenheimer & Co.*, 936 F.2d 759, 762 (2d Cir. 1991). A court need *not* take as true allegations that qualify as legal conclusions, *Ashcroft v. Iqbal*, 556 U.S. __, 129 S. Ct. 1937, 1949 (2009)**,** or are contradicted by facts of which a court may take judicial notice, *Veney v. Wyche*, 293 F.3d 726, 730 (4th Cir. 2002); *Sprewell v. Golden State Warriors*, 266 F.3d 979, 988 (9th Cir. 2001).

Here, the Complaint fails under Rule 12(b)(6) because it seeks a Section 16(b) disgorgement remedy based on a series of transactions that do not, as a matter of law, trigger liability under that statute. *See DeMaria v. Andersen*, 318 F.3d 170, 174 (2d Cir. 2003) (affirming 12(b)(6) dismissal where plaintiff's theory of liability was based on erroneous interpretation of SEC regulations).

ARGUMENT AND AUTHORITIES

I. SECTION 16(b) DOES NOT APPLY WHERE, AS HERE, A STATUTORY INSIDER ENGAGES IN TRANSACTIONS INVOLVING DIFFERENT SECURITIES THAT CANNOT BE CONVERTED INTO, OR EXERCISED FOR, EACH OTHER OR THE SAME SECURITY

As the Supreme Court long ago recognized, Congress enacted Section 16(b) "to curb the evils of insider trading" by adopting a "flat rule" that would "tak[e] the profits out of a class of transactions in which the possibility of abuse was believed to be intolerably great." *Reliance Elec. Co., v. Emerson Elec. Co.*, 404 U.S. 418, 422 (1972). Section 16(b) does not, and was not intended to, "reach every transaction" in which insider information could possibly give an insider an advantage. *Id.* Rather, "[i]n order to achieve its goals, Congress chose a relatively arbitrary rule capable of easy administration." *Id.* (quoting *Bershad v. McDonough*, 428 F.2d 693, 696 (7th Cir. 1970)). That rule requires automatic disgorgement if a statutory insider engages in a purchase and sale, or sale and purchase, of the *same* equity security within a six-month period. *See Levy*, 544 F.3d at 496 (liability under section 16(b) requires "(1) a purchase of a security and (2) a sale *of that security*" within six months) (emphasis added).

In this case, Plaintiff ignores the clear limitations of Section 16(b) and seeks disgorgement based on Mr. Malone's sale of one security (class C shares) and the purchase of another, entirely different security (class A shares)—securities that constitute two separate classes and are not convertible into, or exercisable for, any other security. Notwithstanding the conceded differences between the two securities, *e.g.*, Compl. ¶¶ 15, 17, 21, 23, 45, Plaintiff contends that Section 16(b) disgorgement is available simply

because, according to Plaintiff, Mr. Malone's transactions in class A and class C shares allegedly "giv[e] rise to the kinds of abuses Section 16 is intended to curtail," *id.* ¶ 48.

Plaintiff is wrong. Adopting his novel interpretation of Section 16(b) would improperly re-write Section 16(b) and contravene the courts' and the Commission's long-standing recognition of the statute's limited scope, expanding liability to a new, ill-defined set of transactions never before subject to disgorgement liability.

A. The Text Of Section 16(b) Does Not Permit Matching Transactions That Involve Different Securities

Section 16(b)'s disgorgement requirement is limited, by its terms, to "profit realized" from "the purchase and sale, or sale and purchase, of any equity security of [the] issuer" within a six-month period. 15 U.S.C. § 78p(b).[2] The language and structure of the text make clear that, in order for liability to apply, both the "purchase <u>and</u> sale" must be directed at the same prepositional object—*i.e.*, the *same* "equity security of [the] issuer." *Id.*; *see ConocoPhillips Co. v. U.S.E.P.A.*, 612 F.3d 822, 839 (5th Cir. 2010) ("Nouns joined by coordinating conjunctions are usually treated as a single, compounded unit, and a postmodifying prepositional phrase is most naturally read to modify that single unit.") (citing Sidney Greenbaum, *Oxford English Grammar* 233 (1996)).

Contrary to the relief sought in the Complaint, nothing in the text of Section 16(b) gives any indication that its strict disgorgement requirement can be applied to the sale of one equity security and the purchase of a *different* equity security—let alone one that

[2] The provision provides in relevant part: "any profit realized by [a statutory insider of the issuer] from any purchase and sale, or any sale and purchase, of any equity security of such issuer . . . within any period of less than six months . . . shall inure to and be recoverable by the issuer." 15 U.S.C. § 78p(b).

constitutes an entirely separate class and is not convertible into, or exercisable for, the security that was sold. *See* Compl. ¶¶ 21, 23, Exh. A-14; *infra* at pp. 9–14.

B. Neither The Courts Nor The SEC Have Ever Applied Section 16(b) To Transactions Involving Different Securities That Are Not Convertible Into, Or Exercisable For, Each Other Or The Same Security

Not only does Plaintiff's theory of liability fail under the terms of Section 16(b), it is also unsupported by a shred of precedent. Neither the courts nor the SEC has ever suggested that the statute can be extended to the amorphous class of transactions identified in the Complaint. Indeed, the SEC's treatment of transactions involving derivative securities and their underlying equity securities highlights why Plaintiff's expansive interpretation fails.

1. The Second Circuit Has Interpreted The Statute To Apply To Transactions Involving Fungible Securities, Which Are Not At Issue Here

In an early opinion construing Section 16(b), the Second Circuit contemplated the possibility that the statute, because it requires the purchase and sale of the same security, might be limited to transactions in which literally the same stock certificate was bought and sold. In *Gratz v. Claughton*, Chief Judge Hand observed that "[a]t first blush it might seem that the statute limited the recovery to profits derived from transactions in the same shares; as, for example, that a dealer's profit upon the sale of any given number of shares was to be measured by subtracting what he paid for those shares from what he got upon a sale *of the same certificate*." 187 F.2d 46, 50–51 (2d Cir. 1951) (emphasis added). The court concluded, however, that the statute should not be read so narrowly because like "gallons of oil in a single tank" or "bushels of wheat in a single bin," shares of stock in

the same class are economically "fungible." *Id.* at 51; *see also W. Auto Supply Co. v. Gamble-Skogmo, Inc.*, 348 F.2d 736, 743 (8th Cir. 1965) (adopting *Gratz*'s reasoning and noting that "[s]hares of stock are fungible and each certificate denotes *identical rights*") (emphasis added).

That fungibility does not exist in this case. Shares of class A are not interchangeable with shares of class C—they carry different rights and trade separately and at different prices. Indeed, in *Smolowe*, the first case to match stocks within a single class, the court rejected the idea of matching sales and purchases across different classes as "beyond the realm of judicial fantasy." 136 F.3d at 237 n.13. Since *Smolowe*, no court or commentator has called into question the Second Circuit's "judicial fantasy" observation. *See, e.g.*, Peter Romeo & Alan Dye, *Section 16 Treatise & Reporting Guide* § 12.04 at 1203; Robert W. Hamilton, *Convertible Securities and Section 16(b): The End of an Era*, 44 Tex. L. Rev. 1447, 1489 (1966). Nor has the Commission. Not a single SEC rule, regulation, or other interpretation of Section 16(b) has ever suggested that disgorgement could be required for transactions involving different securities that constitute different classes.[3]

Here, the Complaint acknowledges that class A and class C shares constitute different classes. Compl. ¶¶ 21, 23. Plaintiff has no choice but to make that concession given the fundamental difference between class A's and class C's voting rights. *See, e.g.*,

[3] To the contrary, the Commission has concluded that shares in different classes—including classes that differ only with respect to voting rights—must be counted separately in determining whether an individual can be subject to disgorgement liability *at all* (that is, whether he or she qualifies as a ten-percent owner under Section 16(a)). *See* Crawford & Co., SEC No-Action Letter, Fed. Sec. L. Rep. (CCH) ¶ 79,673, 1991 WL 178739 at *1 (Apr. 19, 1991).

Morales v. New Valley Corp., 936 F. Supp. 119, 125 (S.D.N.Y. 1996) (holding that differences in voting rights, among other distinctions, precluded treating two nominal classes as a single class for purposes of Section 16(a)); Crawford & Co., SEC No-Action Letter, Fed. Sec. L. Rep. (CCH) ¶ 79,673, 1991 WL 178739 at *1 (Apr. 19, 1991) (concluding that a difference in voting rights, by itself, precluded treating two nominal classes as a single class for purposes of Section 16(a)); Jevic Transportation, Inc., SEC No-Action Letter, 1999 WL 232603 at *1 (Apr. 20, 1999) (concluding that "common securities of a single issuer that carry different voting rights" are properly treated as "distinct classes of securities" for the purposes of Rule 144(e)). Plaintiff's concession is fatal to Plaintiff's Complaint under the well-recognized principle in *Smolowe*.

2. The Treatment Of Derivatives Under Section 16(b) Confirms That The Statute Is Inapplicable In This Case

Both courts and the SEC have concluded that Section 16(b) disgorgement can apply to transactions involving a stock and a derivative security if, and only if, the derivative security is convertible into, or exercisable for, that stock or another common security. *See, e.g.*, *Gund v. First Fla. Banks, Inc.*, 726 F.2d 682, 687 (11th Cir. 1984) (matching sales of convertible debentures and purchases of underlying common stock); *T-Bar Inc. v. Chaterjee*, 693 F. Supp. 1, 7 (S.D.N.Y. 1988) (same); *Chemical Fund, Inc. v. Xerox Corp.*, Fed. Sec. L. Rep. (CCH) ¶ 91,653 at 95,419 (W.D.N.Y. 1966), *rev'd on other grounds*, 377 F.2d 107 (2d Cir. 1967) (same); Ownership Reports and Trading by Officers, Directors and Principal Security Holders, SEC Release No. 34-28869, 48 SEC Docket 216, 1991 WL 292000, at *11–19 (Feb. 21, 1991). That conclusion merely

recognizes the indisputable fact that a derivative is the functional equivalent of, and therefore can be treated as identical to, the security underlying it for Section 16(b) purposes. The rationale for applying Section 16(b) to the derivative context is inapplicable in this case—and in fact shows why the statute cannot be extended to the transactions identified in the Complaint.

As the Commission explained in the release accompanying its regulations concerning the treatment of derivatives under Section 16(b): "Holding derivative securities is functionally equivalent to holding the underlying equity securities." 48 SEC Docket 216, 1991 WL 292000, at *11. Buying a derivative is, by definition, buying the right to own the underlying security for a known, fixed price. *Id.* at *11–12. For that reason, "[j]ust as an insider's opportunity to profit commences when he purchases or sells the issuer's common stock, so too the opportunity to profit commences when the insider engages in transactions in . . . derivative securities that provide an opportunity to obtain or dispose of the stock at a fixed price." *Id.* at *11. Based on that economic principle, the Commission and the courts have concluded that the purchase of a derivative security is properly treated as the "purchase of the underlying security for purposes of Section 16(b)." Ownership Reports and Trading by Officers, Directors and Principal Security Holders, 56 Fed. Reg. 7242-01, 7270 (Feb. 21, 1991); SEC Release No. 34-28869, 1991 WL 292000, at *12 n.106 (citing *Gund*, 726 F.2d 682).

The inclusion of transactions involving derivatives is not an exception to the rule that Section 16(b) applies only to trades within the same class. *See supra* p. 10. Rather, the Commission's Rules provide that "both derivative securities and the underlying

securities to which they relate shall be deemed to be the *same class* of equity securities" for Section 16(a) purposes. 17 C.F.R. § 240.16a-4 (emphasis added). Those rules reflect the Commission's recognition that Section 16(b) can only properly apply to trading *within a single class*.

Notably, the Commission *excluded* from the definition of a derivative security for Section 16(b) purposes "securities without a fixed exercise price." SEC Release No. 34-28869, 1991 WL 292000, at *17; Rule 16b-6, 17 C.F.R. § 240.16b-6. When there is no fixed exercise price, holding a convertible or exercisable security is *not* "functionally equivalent to holding the underlying equity security" because the holder does not know in advance what it will cost to move from the derivative to the underlying security. Accordingly, the risk of insider abuse is not the same, and the rationale for extending Section 16(b) is absent. *See* SEC Release No. 34-28869, 1991 WL 292000, at *11, *17 ("Rights without a fixed price do not provide an insider the same kind of opportunity for short-swing profit since the purchase price is not known in advance.").

Here, neither class A nor class C shares are derivative securities as defined by Rule 16b-6. Shares of class A and class C are not convertible into, or exercisable for, each other or any common security. Compl., Exh. A-14. There is no price, fixed or otherwise, at which a class A share becomes a class C share, or vice versa. The lack of a determined conversion or exercise price between class A and class C shares eliminates any basis for analogizing this case to one involving derivatives. If anything, the relationship between the two classes at issue here is analogous to that between a convertible or exercisable security *without* a fixed exercise price and its underlying

security—the holder does not know in advance the price at which it could transform his possession of a share of one class into a share of the other. For reasons the Commission has already made clear, Section 16(b) has no application where securities of that type are involved.

C. The Undisputed Economic Differences Between Class A And Class C Shares, And Their Respective Trading Patterns, Undermine Any Claim That Section 16(b) Could Apply In This Case

The reach of Section 16(b) is clear: It requires disgorgement for transactions that involve securities in the same class, which includes transactions in fixed-exercise-price derivatives and their underlying securities. Beyond that, the statute's strict liability rule is inapplicable. The transactions at issue in this case fall outside Section 16(b)'s well-defined bounds. Any claim that the statute should be stretched to require disgorgement in this case is destroyed by the critical differences between the securities involved.

As Plaintiff acknowledges, the difference between the voting rights of class A and class C shares is an "economically material difference," Compl. ¶¶ 45, 49—one that not only places the shares in different classes, but also undeniably affects the disparate market valuation of the two classes of shares, thereby limiting any opportunity for speculative abuse through cross-class trading.[4] As the price history attached to the

[4] Unlike the price of non-voting stock, the price of voting stock is determined, in part, by the market's estimate of the value of voting rights. As one would expect, when a company has two classes of common stock outstanding, which differ only in their voting rights, the voting stock generally trades at a premium above the non-voting stock, as is the case here. That premium, however, fluctuates over time based on a variety of factors. *See generally* Ronald C. Lease, John J. McConnell, & Wayne H. Mikkelson, *The Market Value of Control in Publicly Traded Corporations*, 11 J. Fin. Econ. 439 (1983); Steven R. Cox & Diane Roden, *The Source of Value of Voting Rights and Related Dividend Promises*, 8 J. Fin. Econ. 337 (2002); Luigi Zingales, *What Determines the Value of Corporate Votes?*, 110 Q. J. Econ. 1047 (1995).

Complaint shows, the difference between the class A and class C share prices varies over time. Accordingly, even accepting Plaintiff's theory that the vote is the only factor affecting market valuation, *but see infra* at pp. 15–17, it is not the case that the price of the vote is fixed or constant. The changing vote value defeats Plaintiff's unsubstantiated claim that an insider "could" make unfair use of insider information by selling shares of class C stock and later buying shares of class A stock. *Id.* ¶ 48. Instead, the indisputable variability in any alleged "vote value" means that whatever "profit" an insider might hope to obtain through such transactions could be wiped out by simultaneous changes in the vote value.

As noted above, it was the unpredictability of price movement that led the Commission to exclude from Section 16(b)'s reach transactions involving convertible or exercisable securities with a *non*-fixed exercise price. *See supra* at pp. 13–14 (discussing SEC Release No. 34-28869, 1991 WL 292000, at *17). The same logic confirms why it would make no sense to impose Section 16(b)'s disgorgement requirement to the transactions involving class A and class C shares at issue here.[5]

In any event, the difference in the voting rights between class A and class C is *not* the only factor driving the different pricing of these two different classes of stock—as the price history attached to the Complaint indisputably demonstrates. As that price history

[5] The Complaint alleges that the share prices of class A and class C stock are "highly correlated," creating risk of "the kinds of abuses Section 16 is intended to curtail." Compl. ¶ 48. Setting aside that Section 16(b) is not triggered by the existence of a risk of abuse, that argument ignores the fact that the *difference* between the two classes changes constantly, *see id.*, Sched. III, significantly undermining an insider's ability to predict pricing. That Mr. Malone actually *lost* money on some of Plaintiff's matched transactions, *see* Exh. B, demonstrates this point.

shows, the respective share prices of the two classes moved in opposite directions on fifteen trading days during the twenty-three-week period identified in the Complaint. During that same period, the price of the class C shares closed *higher* than the price of class A shares on five separate occasions. *See supra* at p. 4. Neither of those things could have occurred if the value of the vote were the *only* factor affecting the difference in price between class A and class C shares. To the contrary, if Plaintiff's allegation that the vote is the only factor driving price difference, it would mean that, on the days that the class A shares closed at a price lower than the class C shares closed, the value of the vote was *negative*, which is, of course, an economic impossibility.[6]

As the materials attached to the Complaint make plain, the difference in voting rights cannot be the only "economically material difference" driving the price difference between class A and class C shares. In fact, there are multiple other distinctions between these two classes that may affect market pricing. For example, during the time period covered by the Complaint, there was an options market for class A shares but not for class C shares. *See supra* at p. 4. The presence of those options likely made the market for class A shares more efficient than the market for class C shares.[7] Differences in

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[6] Even if voting rights are worthless, a rational investor would always pay at least the price of the non-voting shares since both voting and non-voting shares have the same cash flow rights. *See* Haim Levy, *Economic Evaluation of Voting Power of Common Stock*, 38 J. Fin. 79 (1983); Robert Neumann, *Price Differentials Between Dual-class Stocks: Voting Premium or Liquidity Discount?*, 9 Eur. Fin. Mgmt. 315 (2003).

[7] *See generally* Raman Kumar, Atulya Sarin, & Kuldeep Shastri, *The Impact of Options Trading on the Market Quality of the Underlying Security: An Empirical Analysis*, 53 J. Fin. 717 (1998).

market efficiency can, in turn, affect how different shares trade.[8] A second clear difference between the two classes is that class A is subject to change in the number of shares outstanding because of the convertibility of class B shares into class A shares; the potential for change in outstanding share-volume could undoubtedly affect the market's valuation of class A shares. Class B shares do not, however, convert into class C shares, meaning that class C is not subject to the same effect. A third difference is that class A shares and class C shares carry different rights regarding share distribution. *See supra* at p. 3.

Section 16(b)'s bright-line rule—which is clearly inapplicable to the transactions at issue here—eliminates any need for the Court to engage in a complicated assessment of the factors that cause disparate fluctuations in the prices of class A and class C shares. These differences, however, underscore why applying Section 16(b) in this case should remain "beyond the realm of judicial fantasy." *See Smolowe*, 136 F.2d at 237 n.13; Romeo & Dye, *supra*, § 12.04 at 1203 (explaining that where "the value of two distinct classes fluctuates on the basis of different factors . . . there presumably would be very little or no opportunity for speculative abuse" and therefore "no reason to invoke Section 16(b)").

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[8] Richard A. Brealey, Stewart C. Myers, & Franklin Allen, *Principles of Corporate Finance* 336–55 (8th ed. 2006) (more efficient markets more accurately reflect the true value of a stock).

II. ADOPTING PLAINTIFF'S EXPANSIVE INTERPRETATION WOULD DESTROY THE BRIGHT-LINE, PREDICTABLE RULE SECTION 16(b) WAS MEANT TO CREATE

Section 16(b)'s disgorgement requirement applies to transactions involving the same security in the same class—and no others. The limited and well-defined scope of the rule makes sense given its basic purpose: to target those transactions that pose the greatest risk of insider abuse but, at the same time, to provide a straightforward rule that is easy for courts to apply and statutory insiders to follow. Plaintiff's unprecedented interpretation of Section 16(b)—as applying to *any* transactions that may "giv[e] rise to the kinds of abuses Section 16 is intended to curtail," Compl., ¶ 48—would defeat that purpose entirely, and destroy the balance Congress struck when it enacted the statute. It would invite a wave of Section 16(b) lawsuits that would throw courts, and statutory insiders, into exactly the "maze of guesswork and confusion" the statute was designed to avoid. *See Morales*, 936 F. Supp. at 124. It would be one thing if Section 16(b) were the only vehicle available for addressing alleged insider abuse. But it is not. There are myriad other remedies available outside the same-security context, and therefore absolutely no basis for extending Section 16(b)'s strict liability rule beyond what Congress plainly intended.

A. Adopting Plaintiff's Interpretation Of Section 16(b) Would Impose A Severe Burden On Courts

Under Plaintiff's reading of the statute, courts would be required to assess the differences and similarities between two securities—including the rights, privileges, and preferences of each (*e.g.*, voting, distribution, and consent rights) as well as their market

characteristics (*e.g.*, existence of a market of third-party options, liquidity and volatility) and then determine, based on that assessment, whether the similarities are sufficient to "giv[e] rise to the kinds of abuses Section 16 is intended to curtail." That standard is really no standard at all. It gives no guidance as to how significant the similarities between the different securities must be; how much potential for insider abuse is enough; and what kinds of differences, if any, are sufficient to remove transactions from Section 16(b)'s reach. Those difficult questions, and the burden courts would face in trying to answer them, is what Congress sought to avoid with Section 16(b)'s "flat rule." *See Reliance Elec.*, 404 U.S. at 422.

Plaintiff's interpretation would also require courts to determine what profits, if any, an insider may have realized by buying shares of one class of one equity security and selling shares of another class—an exercise that is difficult, if not impossible, to perform. As one commentator concluded, where the purchase of one class of stock is to be matched with the sale of a *different* class of stock "it is no more possible to compute a profit . . . than it is to compute a profit from a purchase of oranges and a sale of an automobile." Hamilton, *supra*, at 1489 (1966). Indeed, under those circumstances, "courts would simply be guessing whether the insider had realized a profit" at all. Romeo & Dye, *supra*, § 12.04 at 1203.

The impossibility of measuring profits where one security is purchased and a *different* one sold is well-illustrated by this case. As an initial matter, it is worth noting that Mr. Malone's cash position went *down*, not up, in two of the matched transactions alleged in the Complaint and did not change at all in another. Exh. B (chart, based on

exhibits to the Complaint, comparing actual purchase prices to sale prices for challenged transactions). That Plaintiff is seeking disgorgement based on transactions that netted no cash shows just how far-fetched his claim for relief is.

Plaintiff does construct a *theory* of profit, in which he adjusts the class A price to hypothesize a new, "deemed" purchase price. Compl. ¶ 50. But, aside from being entirely hypothetical, that theory is otherwise fatally flawed. Plaintiff appears to posit as follows: (1) the value of a class A share is simply the value of a class C share plus the value of the vote, *id.* ¶ 49; (2) therefore, "the appropriate measure of the equity value of each stock on any given day" is the price of class C stock, *id.*; (3) accordingly, the "appropriate measure of short-swing profit may only be determined by using a deemed purchase price for the Series A Stock equal to the price of Series C Stock at the time of purchase, which eliminates the cost of vote-acquisition from the computation." *Id.* ¶ 50.

But Plaintiff's theory fails at its premise. As set forth above, it is not the case that the "only economically material difference" between a share of class A stock and a share of class C stock is the right to vote. *Id.* ¶¶ 45, 49. As a result, profit *cannot* be "appropriate[ly]" measured by substituting the price at which Mr. Malone purchased his class A shares for the lower price at which class C shares were trading. To the contrary, that substitute pricing creates an appearance of profit that, as a matter of fact, does not exist at all.

With Plaintiff's proposed theory of profit debunked, the Court is left with no guidance at all as to how to measure profit in this mis-matched case. The same would be true in all mis-matched cases going forward. The problem of measuring profits where

transactions involve *different* securities confirms that Section 16(b) should be limited, as its terms require, to *same*-security transactions.

B. The Standard Plaintiff Advocates Would Be Unfair To Insiders And Could Ultimately Harm The Very Investors The Act Is Meant To Protect

Plaintiff's interpretation of Section 16(b) would not only be unworkable for courts to apply, it would also be difficult, if not impossible, for statutory insiders to follow. As it stands, with liability limited to transactions involving the same equity security, insiders are generally on notice of which transactions will be subject to disgorgement. But if the statute's now bright-line rule is replaced with Plaintiff's ambiguous standard, it will be virtually impossible for insiders to know, with any certainty, whether Section 16(b) is applicable. That uncertainty is likely to stifle perfectly legitimate transactions that involve no abusive use of insider information. It is well-recognized that legitimate trading by insiders benefits the markets by "contribut[ing] significantly to faster price discovery on insider trading days." Nihat Aktas, Eric de Bodt, & Hervé Van Oppens, *Legal insider trading and market efficiency*, 32 J. Banking & Fin. 1379, 1391 (2007). Stifling that trading could therefore ultimately harm the very investors that the 1934 Act was meant to protect.

Aside from harming investors writ large, Plaintiff's interpretation would also result in significant unfairness to statutory insiders, including Mr. Malone. As various courts have recognized, the "flat rule" of Section 16(b) often has the effect of penalizing investors who have made no improper use of insider information whatsoever. *See, e.g.*, *Magma Power Co. v. Dow Chem. Co.*, 136 F.3d 316, 320–21 (2d Cir. 1998) (Section

16(b) "penaliz[es] technical violators of pure heart, and bypass[es] corrupt insiders who skirt the letter of the prohibition"). That "arbitrary, some might say Draconian" result is the price, and inevitable consequence, of Congress's decision to adopt a strict liability, "bright-line" rule. *Blau v. Lamb*, 363 F.2d 507, 515, 526 (2d Cir. 1966); *Magma Power*, 136 F.3d at 321 ("'Such is the price of easy administration.'") (quoting Robert Charles Clark, *Corporate Law* 295–96 (1986)). That "Draconian" impact should not, however, be exacerbated by imposing Section 16(b) liability beyond the narrow category of transactions to which it is so obviously limited. *See Kern County Land Co. v. Occidental Petroleum Corp.*, 411 U.S. 582, 594–95 (1973) (courts must "endeavor[] to implement congressional objectives without extending the reach of the statute beyond its intended limits").

Acknowledging the often "harsh result of imposing [Section] 16(b)'s liability without fault," the Supreme Court has admonished that "courts should not be quick to determine that, despite an acknowledged ambiguity, Congress intended the section to cover a particular transaction." *Foremost-McKesson, Inc. v. Provident Sec. Co.*, 423 U.S. 232, 252 (1976) (noting that "serving the congressional purpose does not require resolving every ambiguity in favor of liability" under the statute); *see also Levner v. Saud*, 903 F. Supp. 452, 461 (S.D.N.Y. 1994) ("[T]he Supreme Court has stressed a narrow approach to the statutory construction of § 16(b).") (citation omitted)). That warning is all the more reason to reject the expansive reading of Section 16(b) advanced in the Complaint.

C. Plaintiff's Interpretation Is Unnecessary To Combat Insider Trading

Confining Section 16(b) to its terms—*i.e.*, to transactions involving the same equity security—will not undercut the effort to curb the problem of insider trading. For one thing, as Congress recognized in enacting Section 16(b), transactions involving *different* securities, that have different features and different trading patterns, do not pose the same risk of insider trading, and therefore do not warrant the same strict-liability approach.

Whatever opportunity for speculative abuse *may* exist outside the context of same-security transactions is met by the myriad other mechanisms Congress and the Commission have put in place to target potential insider-trading issues. *See, e.g.*, Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j (prohibiting securities fraud and manipulation); Rule 10b5-1, 17 C.F.R. § 240.10b5-1 (defining fraud under the Exchange Act to include trading on the basis of inside information); Rule 10b5-2, 17 C.F.R. § 240.10b5-2 (prohibiting insiders from "tipping" family members or others); Rule 14e-3, 17 C.F.R. § 240.14e-3 (prohibiting anyone in possession of material information about a tender offer obtained from an insider from trading on that information). Severe civil and criminal penalties apply under these laws if there is proof that an insider based a sale on inside information. *See, e.g.*, 15 U.S.C. § 78t-1 (enabling traders to bring civil actions to recover the profits that insiders gained or the losses that insiders avoided); 15 U.S.C. § 78u-1 (authorizing civil SEC enforcement actions and civil penalties of three times the profits gained or the losses avoided); 15 U.S.C. § 78ff(a) (authorizing fines of up to $5 million and prison sentences of up to twenty years).

These mechanisms, taken together, "alleviate concern that ordinary investors are unprotected against actual abuses of inside information in transactions not covered by [section 16(b)]." *Foremost-McKesson*, 423 U.S. at 255; *At Home Corp. v. Cox Commc'ns, Inc.*, 446 F.3d 403, 410 (2d Cir. 2006) ("[Section] 16(b) is simply not an antidote to all the ills that may plague the securities market.") (quotation marks and citation omitted). Accordingly, there is no need—in this case or any other—to eviscerate the bright-line rule Congress sought to create.

CONCLUSION

For the reasons set forth above, Mr. Malone respectfully requests that the Court grant his Motion to dismiss the Complaint under Federal Rule of Civil Procedure 12(b)(6).

Dated: January 31, 2011

Respectfully submitted:

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